CORPORATIONS COMMITTEE
BUSINESS LAW SECTION
THE STATE BAR OF CALIFORNIA
180 HOWARD STREET
SAN FRANCISCO, CA 94105-1639
http://www.calbar.org/buslaw/corporations

December 19, 2003

Via E-Mail: rule-comments@sec.gov

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: SEC File No. S7-19-03
Release Nos. 34-48626; IC-26206
Proposed Rules under the Securities Exchange Act of 1934
and the Investment Company Act of 1940
"Proposed Rule: Security Holder Director Nominations"

Dear Mr. Katz:

We are writing to comment on the above-referenced release and proposal (the "**Release**") issued by the Securities and Exchange Commission (the "**Commission**"). These comments are provided by the Corporations Committee (the "**Committee**") of the Business Law Section of the State Bar of California (the "**Business Law Section**"). Please note that the views and positions set forth in this letter are only those of the Committee. As such, they have not been adopted by the State Bar's Board of Governors, its overall membership or the overall membership of the Business Law Section, and are not to be construed as representing the position of the State Bar of California. **Membership in the Business Law Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources. There are currently more than 9,500 members of the Business Law Section.**

I. SUMMARY OF COMMENTS

The Release outlines a series of proposed rules (the "**Proposed Rules**") under which certain shareholders of a company could, upon the occurrence of specified triggering events, nominate candidates to serve on the board of directors using the company's own proxy materials. The Committee, in this comment letter, will focus on the interplay between the Proposed Rules

and California state law (and, by extension, state law generally). The Committee's comments on the Proposed Rules are summarized as follows:

- That the Commission clarify, if the Proposed Rules are adopted, that they would be inapplicable not only when they conflict with controlling state law expressly prohibiting a company's security holders from nominating a candidate for election as director, but also when they are inconsistent with state law, and articles and bylaw provisions adopted pursuant to state law, providing for rights, restrictions and procedures that vary from the rights, restrictions and procedures set forth in the Proposed Rules.

- That the Proposed Rules, if adopted, apply only to "accelerated filers," and that implementation of the Proposed Rules be delayed for one year from adoption.

- That the Commission clarify, if the Proposed Rules are adopted, that they do not supplant or override state law provisions granting voting rights only to record, as opposed to beneficial, owners of shares.

- That the Commission clarify, if the Proposed Rules are adopted, that in calculating the number of "withhold" votes under the Proposed Rules, broker non-votes not be calculated as "withhold" votes.

II. COMMISSION QUESTIONS ADDRESSED.

In this letter, the Committee addresses the following questions posed by the Commission in the Release:

> [Question B.3] Would adoption of this procedure conflict with any state law, Federal law or rule of a national securities exchange or national securities association? To the extent you indicate that the procedure would conflict with any of these provisions, please be specific in your discussion of those provisions that you believe would be violated.[1]

and

> [Question H.7] As proposed, Exchange Act Rule 14a-11 includes a number of notice and other timing requirements. Should these timing requirements incorporate or otherwise address any advance notice provisions under state law or a company's governing instruments? If so, should any advance notice provisions govern? Should they instead be provided as an alternative to the timing provisions set out in the rule?[2]

III. CALIFORNIA LAW

Corporate law in California, as embodied in both statutes and judicial decisions, has pursued for many years the shareholder democracy goals that apparently serve as the catalyst for the Proposed Rules. The California Corporations Code (the "**Code**") provides for uniform rights for classes and series of shares with no distinctions among the holders thereof,[3] shareholder inspection rights,[4] and special shareholder remedies for failure to hold an annual meeting.[5]

The Code provides that directors of California corporations are elected by a plurality of the shares represented at a meeting, unless the vote of a greater number is required by the articles, or by unanimous written consent if elected by written consent without a meeting.[6] Except as otherwise provided in the articles of incorporation, shareholders of a California corporation are entitled to cumulate their votes in the election of directors.[7]

The articles of a California corporation need not specify the authorized number of directors[8] and this is instead frequently covered in the bylaws. Adjustments in the number of directors, if not specified in the articles, may be effected by the board without shareholder action if the bylaws provide for an indefinite number of directors, within the range of a minimum (but not fewer than three) and maximum (which may not be greater than two times the minimum minus one) stated in the bylaws.[9] Listed corporations[10] may amend their articles or bylaws to provide for two or three classes of directors.

The Committee believes that the corporate governance provisions noted above are fundamentally matters of state law which the Commission should respect.

IV. CONFLICT WITH GOVERNANCE PROVISIONS

In the Release, the Commission explained that the Proposed Rules would be applicable in the following circumstances:

> [A]s proposed, a company would become subject to the security holder nomination procedure in Exchange Act Rule 14a-11 only where the company's security holders have an existing, applicable state law right to nominate a candidate or candidates for election as a director. To eliminate any uncertainties in this regard, the proposed rule would state that the security holder nomination procedure would be available unless applicable state law prohibits the company's security holders from nominating a candidate or candidates for election as a director. If state law permits companies incorporated in that state to prohibit security holder nominations through provisions in companies' articles of incorporation or bylaws, the proposed procedure would not be available to

security holders of a company that had included validly such a provision in its governing instruments.[11]

In California, statutory law neither requires nor prohibits the inclusion of shareholder nominees in a company's annual meeting proxy materials. Code Sections 204(d) (governing optional provisions that may be included in the articles of incorporation) and 212(b) (governing permissible bylaw provisions) permit California corporations to include in their articles and bylaws any provision "not in conflict with law" for the management of the business and for the conduct of the affairs of the corporation. This broad discretion is bounded by judicial decisions that prohibit inequitable procedures. One of the leading California cases on corporate governance emphasizes a "fair and reasonable" standard for director nominations: "Fair and reasonable election procedures are fundamental to the proper governance of . . . corporations. [Candidates] should have a reasonable opportunity to be nominated and elected to the board . . . ." *Braude v. Automobile Club of Southern California*, 178 Cal.App.3d 994, 1012 (1986).[12]

Even if a California corporation may not or does not prohibit shareholder nominations, it otherwise enjoys great flexibility in adopting provisions governing the nomination of directors. In general, the specific procedures concerning director nominations are left to the articles of incorporation or, more frequently, the bylaws of the company, shareholder agreements or the applicable procedures governing the conduct of the meeting. Shareholder proposals, including proposals relating to the election of directors, may be offered before a shareholders meeting or they may be raised at the meeting. During the annual meeting, in the absence of specific procedures in the articles of incorporation, the bylaws or an applicable shareholder agreement, shareholders normally may nominate director candidates from the floor,[13] and Section 708(b) of the Code requires the prior nomination of director candidates before shareholders may exercise their statutory right to cumulate their votes.

As a result, director nomination provisions for California corporations can, and often do, differ from the procedures set forth in the Proposed Rules. For example, the provisions may include:

- a requirement that no person shall be eligible for election as a director unless advance notice is provided to the corporation (including specific time period and information requirements);

- a requirement that no nominee shall be eligible for election unless approved by the nominating committee (irrespective of whether a shareholder nominated the person);

- a requirement for a shareholder motion before a vote may be taken on a director nominee's candidacy;

- an agreement as to which specific individuals, or classes of individuals, will serve on the board; or

- a provision granting a specific class or series of shares the right to approve specific directors.

These are just some examples – there could be numerous variations on these or other matters. In many of these cases, the Proposed Rules could be inconsistent with the articles of incorporation, bylaws or contractual provisions. As a result, corporations would be faced with either complying with two sets of procedures or choosing which one to follow in the face of a conflict. Needless to say, violating one set of rules to comply with the other could lead to different sources and types of liability to corporations and their directors.

If the Commission decides to adopt the Proposed Rules, they should be modified to address the concerns raised above with respect to the potential inconsistencies with applicable state law and arrangements adopted in compliance with state law. The Committee believes that California corporate law should not be rendered irrelevant by the Proposed Rules. Indeed, nothing in the Release suggests that the Commission intends the Proposed Rules to preempt state law.[14] The Commission appears to have designed the Proposed Rules to avoid conflicts with state law. As discussed above, however, these provisions need to be clarified and strengthened in order to achieve that goal. Therefore, if the Commission proceeds to adopt the Proposed Rules, the Committee recommends amending them to provide that to the extent that the Proposed Rules are inconsistent with applicable state law or rights, restrictions or procedures adopted pursuant to such law, the applicable state law, right, restriction or procedure shall apply.

V. CONFLICT WITH RIGHTS OF RECORD HOLDERS

Only record holders of a corporation's shares have the right to vote or take action as shareholders under the Code.[15] As a practical matter, actions of beneficial owners, including voting, are accomplished by directing record holders (usually The Depository Trust Company) to take such action. The Proposed Rules would provide beneficial owners with substantive rights to which they are not entitled under California law. This differs from existing proxy requirements concerning beneficial owners, which are generally limited to providing beneficial owners with specified proxy disclosure and the opportunity to submit proposals to a nonbinding shareholder vote under certain circumstances. In contrast, the Proposed Rules grant beneficial owners the direct right to nominate directors, which is one of the most basic corporate rights that shareholders possess. The Committee opposes granting beneficial owners substantive rights that conflict with the rights granted to record owners under California law.

VI. COMPLIANCE CONCERNS

In response to Question B.1 of the Release, the Committee wishes to register its deep concern with the additional burden the Proposed Rules would impose on all corporations, but in particular small corporations. In Section II(A)(2)(b) of the Release, the Commission discusses several reasons for limiting the application of the Proposed Rules to "accelerated filers," including:

- avoiding the disproportionate burden the Proposed Rules may impose on smaller companies;
- allowing Commission staff and capital markets to gain experience with the Proposed Rules before subjecting smaller companies to them; and
- targeting the Proposed Rules to that class of larger companies that have generated most of the interest in the proxy reform (*i.e.*, accelerated filers).

The Committee finds these reasons persuasive, and notes that there is little risk in initially excluding the smaller companies that are not accelerated filers (many of which are incorporated or headquartered in California) from the burden of the Proposed Rules. As a result, if the Commission adopts the Proposed Rules, the Committee recommends limiting the Proposed Rules to corporations that are accelerated filers.

The Committee notes that the Proposed Rules would represent a fundamental change in the proxy process, for which corporations will need to prepare. Public companies in California are already spending substantial time and efforts, as well as recruiting new directors, to comply with the Sarbanes-Oxley Act and the new New York Stock Exchange and Nasdaq corporate governance rules. A delay would give companies time to prepare and focus on implementing other required procedures. Accordingly, if the Commission adopts the Proposed Rules, the Committee recommends that implementation of the Proposed Rules be delayed for at least a year from adoption.

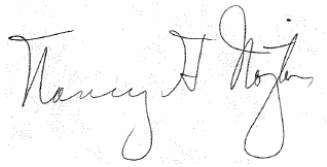
Under the Proposed Rules, one of the events triggering the shareholder nomination procedure is a company nominee for the board receiving "withhold" votes from more than 35% of the votes cast at an annual meeting, subject to certain exceptions.[16] This triggering event is intended to be evidence of shareholder dissatisfaction with a company's proxy process. In this light, the Committee believes the most reasonable interpretation of the Proposed Rules is that broker non-votes should not be considered "withhold" votes, though this point is not directly addressed in the Release. Accordingly, the Committee requests the Commission to confirm that broker non-votes are not to be considered "withhold" votes under the Proposed Rules.

VII. CONCLUSION

The Committee would oppose adoption of the Proposed Rules if the clarifications requested and revisions suggested herein are not made. Even if they are made, however, the Committee notes that this letter is limited to addressing the state law issues raised in the Release, and wishes to emphasize that nothing contained herein should be construed as support for the Proposed Rules.

The Committee appreciates the opportunity to comment to the Commission on the Proposed Rules. The members of the Drafting Committee listed below would be pleased to discuss any questions the Commission may have with respect to this letter.

Steven K. Hazen
Co-Chair



Nancy H. Wojtas
Co-Chair

Drafting Committee

Victor Hsu, Esq.
Fulbright & Jaworski L.L.P.
865 S. Figueroa Street, 29th Floor
Los Angeles, CA 90017
(213) 892-9326
vhsu@fullbright.com

Steven B. Stokdyk, Esq.
Sullivan & Cromwell LLP
1888 Century Park East
Los Angeles, CA 90067
(310) 712-6624
stokdyks@sullcrom.com

James F. Fotenos, Esq.
Greene Radovsky Maloney & Share LLP
Four Embarcadero Center, Suite 4000
San Francisco, CA 94111
(415) 981-1400
jfotenos@grmslaw.com

Brian M. Wong, Esq.
Pillsbury Winthrop LLP
50 Fremont Street
San Francisco, CA 94105
(415) 983-6372
bwong@pillsburywinthrop.com

The State Bar of California Business Law Section
Corporations Committee Members

As of the date of this letter, the Corporations Committee is composed of the members shown below. Each and every view or position in this letter are not necessarily endorsed by each member, but taken as a whole, however, the comments contained herein reflect a consensus of the members of the Corporations Committee.

Steven K. Hazen, Co-Chair
James F. Fotenos,
Vice-Chair, Legislation
Randall Brent Schai,
Vice-Chair, Education
Curt C. Barwick
John C. Carpenter
Matthew R. Gamello
Victor Hsu
John H. Marlow
Deborah J. Ruosch
Teri Shugart
Steven B. Stokdyk
Daniel J. Weiser

Nancy H. Wojtas, Co-Chair
Brian D. McAllister,
Vice-Chair, Communications
Stewart Laughlin McDowell,
Secretary
Keith Paul Bishop
James K. Dyer, Jr.
Mark T. Hiraide
Brian A. Lebrecht
Cynthia Ribas
William R. Sawyers
Lemoine Skinner, III
Suzanne L. Weakley
Brian M. Wong

NOTES:

[1] Release § II(A)(2)(c); 68 Fed. Reg. 60,784, 60,789 (Oct. 23, 2003).

[2] Release § II(a)(8)(c); 68 Fed. Reg. at 60,800.

[3] Code §§ 203, 400(b).

[4] Code §§ 213, 1601.

[5] Code § 600(c).

[6] Code §§ 602(a), 603(d), 708.

[7] Code § 708.

[8] Code § 202.

[9] Code § 212(a).

[10] Code § 301.5(d) defines listed corporations as those with outstanding shares listed on the New York Stock Exchange or the American Stock Exchange or with outstanding securities listed on the National Market System of the Nasdaq Stock Market.

[11] Release § II(A)(2)(a); 68 Fed. Reg. at 60,787–8 (footnote omitted).

[12] *See also Braude v. Automobile Club of Southern California*, 78 Cal.App.3d 178, 189 (1978) (Beach, J., dissenting) (majority opinion requires defendant to comply not only with Corporations Code but also equitable "fair and just" standard); and *Braude v. Automobile Club of Southern California*, 38 Cal.App.3d 526, 532-33 (1974) ("Incumbent directors may not use the corporate proxy machinery solely to perpetuate themselves in office . . . . Bylaws seemingly in compliance with statutory provisions are invalid if they are unreasonable").

[13] 1 NEAL H. BROCKMEYER ET AL., COUNSELING CALIFORNIA CORPORATIONS § 3.38 (2d ed. 2003).

[14] The Committee also has a concern as to whether the SEC has the authority to preempt state law in this area, which is beyond the scope of this letter.

[15] Code § 185.

[16] Release § II(A)(3)(a); 68 Fed. Reg. 60,789.